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DISRUPTING ECONOMIC DEVELOPMENT WITH FOREIGN AID

by

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There has been a consensus in the U.S. for a number of years that rapid economic development in friendly or neutral countries promoted our national interests. Economic aid has been an important part of this promotion since World War II. Over time the philosophy and mix of aid activities have changed substantially (Mikesell). Technical assistance, institution building, training, food commodities, and trade concessions played a much larger role in assistance during the 50s and 60s than they have the past decade. Increasingly, large capital loans have come to dominate the aid basket.

Various cross currents of interests in foreign aid often obscure the principal purpose that causes giver and receiver to be involved in aid. Namely, that the aid helps to accelerate the rate of economic growth in the receiving country, helps to ease at least some of the poverty there, and also results in less turbulent societies. In the discussion that follows, I argue that large amounts of donor assistance too often helps to sustain policies that retard growth, further distort income distributions, and also cause more turmoil in low income countries.

Criticisms of Aid

Since the early 1970s it has become increasingly difficult to find aid success stories, and too easy to identify countries where economic conditions have deteriorated. If economies had nervous breakdowns, many of the low income countries would be on the "shrinks" couch. There are several explanations for this scarcity of recent development success stories: energy price increases, rapid population growth, declines in the prices of major exports, droughts, and wars. Even more commonly, incorrect economic policies have brought third world countries to their knees.

I continue to feel that foreign aid can be useful, despite its shortcomings. My concern is with the current mix of activities, and especially with the large amounts of assistance that may be causing some of the current distress experienced in low income countries. The problems with this assistance lie in three related areas: large amounts of food aid allow governments to sustain low food price policies; large amounts of capital assistance, complemented by additional commercial loans, may allow governments to postpone making adjustments in foreign exchange rate policies to the point where major instead of minor adjustments are necessary; and much of the aid that goes to countries in financial form moves through local financial markets. This aid may reinforce financial policies that cause misallocation of resources, cause further income and asset ownership concentration, and also undermine the vitality of the financial market itself.

Recent events in Egypt, Costa Rica and the Dominican Republic illustrate how large amounts of foreign aid have been associated with damaging policies.

Egyptian Agricultural Prices

A major anomaly in economic policies is that high income countries often maintain price supports on agricultural products that result in excess production and disposal programs, while many of the low income countries set price ceilings on major agricultural products that discourage production and force the country to import substantial amounts of food. These policies, combined with population increases, have resulted in many low income countries becoming increasingly dependent on high income countries for food. For the past couple of decades some students of development have been concerned with the impact of large amounts of commodity imports under P.L. 480 programs on farmers' prices in aided countries (Schultz, 1960, for example). Despite these criticisms large amounts of food aid continue to make up a significant part of the assistance given to some low income countries.

One of the largest recipients of food aid is Egypt. During the past couple of decades it has increasingly depended on food imports. In part, this is due to faltering growth in yields and switching by farmers from the production of major commodities such as cotton and wheat to vegetables, fruits, and livestock.

Egypt's agricultural growth rates in recent years have lagged behind population growth rates, and this has forced the country to import 70 percent of all wheat used and to allow food imports to make up more than one-quarter of the value of all imports (Scobie). As can be noted in Table 1, Egypt's cereal imports, most of which are wheat, have roughly quadrupled since the early 1960s. At the same time the volume of cotton exports, a very important source of foreign exchange, was less than half in 1980 of the early 1960s volume. It can also be noted that the ability of Egypt to pay for its food imports through agricultural exports has fallen, especially since 1972. In 1978 the value of agricultural imports, mostly food, was almost three times as large as the total value of agricultural exports. In contrast, the value of agricultural exports in the early 1960s was about double the value of food imports. Increasingly, Egypt is loosing the ability to feed itself.

For those who understand the role that prices play in farmers decisions, one does not have to look far to find an explanation for Egypt's food problems. For a number of years the governments of Egypt have maintained price controls, imposed forced sales to the government and overvalued exchange rates that result in average farm gate

Table 1. Egypt's Agricultural Imports and Exports, 1960-1980

	Cotton Exports		Cereal Imports[a]		Wheat Imports[b]		Value Ratios of		
	Thousand M.T.	Million $	Million M.T.	Million $	Million M.T.	Million $	Ag. Imports/ Total Imports	Ag. Exports/ Total Exports	Ag. Imports/ Ag. Exports
1960	374	387	1.4	76	1.3	71	.32	.81	.45
1962	225	208	1.8	117	1.6	102	.33	.71	.90
1964	291	268	2.3	171	1.9	143	.33	.73	.81
1966	348	330	2.4	161	2.3	150	.31	.71	.77
1968	269	276	2.4	144	2.3	136	.37	.70	.57
1970	285	340	1.3	70	1.2	66	.27	.67	.41
1972	295	373	1.8	119	1.7	114	.31	.61	.55
1974	232	714	3.0	739	2.6	670	.51	.65	1.22
1976	165	396	3.4	564	2.9	486	.36	.48	1.85
1978	133	336	5.9	804	5.1	706	.29	.38	2.98
1980	148	423	6.0	1,140	5.4	1,035	N/A	N/A	N/A

a/ Mainly wheat and corn.

b/ Includes wheat products in raw wheat equivalents.

Source: Food and Agriculture Organization (FAO), Trade Yearbook, various issues.

prices being far below prices that prevail in international markets. In recent years the government has sold primary agricultural commodities to consumers at prices that are even lower than those paid to farmers. Recently, food subsidies equaled about 20 percent of all government revenues, and the subsidies for wheat and wheat flour alone came to 10 percent of government revenues (Scobie).

As can be noted in Table 2, the price distortions were especially large for cotton and rice with producers receiving less than one-quarter of the international price, using market rates of exchange for the Egyptian pound. Producers of other major agricultural products, including wheat, received only from 40 to 66 percent of the world market price. It is no surprise that farmers have shifted out of the production of goods with price controls to enterprises that do not carry these price disincentives.

As El-Amir and others reports, the terms-of-trade for wheat and corn have been more seriously affected by pricing policy than is true of rice or cotton, especially since 1973-74. This is no accident. Major imports of both wheat and corn, partly funded by P.L. 480 and partly by foreign assistance, began in 1973-74. The decline in the terms-of-trade for these two commodities is clearly associated with the increase in the imports of these two goods. It is highly unlikely that Egypt would have been able to maintain these low food prices and turn the terms-of-trade against

Table 2. External and Internal Prices for Major Agricultural Products in Egypt, 1980

	International Prices Using Exchange Rate*		Internal Prices		Ratios			
Product	Market	Official	Paid to Farmers	Paid by Consumers	3/1	3/2	4/1	4/2
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	-In Egyptian Pounds Per Metric Ton-				-Ratios-			
Rice	320	269	75	50	.23	.28	.16	.19
Wheat	133	112	77	41	.58	.69	.31	.37
Sugar	436	366	177	100	.41	48	.23	.27
Beans	243	204	161	100	.66	.79	.41	.49
Lentils	441	370	250	110	.57	68	.25	.30
Cotton	959	806	230	333	.24	.29	.35	.41

* In 1980 the market exchange rate of one U.S. dollar was .84 Egyptian pounds, while the official exchange rate was .70.

Source: Adapted from Strategy for Accelerated Agricultural Development Team, "Egyptian Agricultural Policy: Diagnosis and An Adjustment Agenda". An unpublished report prepared for the Agency for International Development in Egypt, Cairo, Egypt, April 15, 1982.

wheat and corn producers without the availability of large amounts of foreign food assistance.

Costa Rican Exchange Rates

Recently, a number of low income countries have undergone economic stress due to increases in the costs of energy imports, worldwide and internal inflation, and declining prices for principal exports. Costa Rica is a particularly interesting case to study because it has been, until recently, an island of stability and democracy in a Central American sea of turmoil.[1/] In late 1981 Costa Rica was forced to announce a moratorium on payment of foreign debt. Soon its exchange rate for dollars shot up from less than 9 colones per dollar to over 50; it experienced substantial foreign capital flight; it incurred triple digit inflation; it had negative rates of economic growth; and it was forced into the clutches of the International Monetary Fund. This was a tremendous shock for a country that had realized economic growth rates of around 6 percent per year since the early 1960s and had been classified as an excellent credit risk by commercial banks and aid donors (Cespedes and Gonzalez-Vega).

The roots of these problems can be traced to events in the mid-to-late 1970s. In 1976-79 the price of coffee, a major export of Costa Rica, was relatively high, along with

1/ I am indebted to Claudio Gonzalez-Vega for background material, insights and interpretations of what went on in Costa Rica over the past few years.

prices on other principal exports. As can be noted in Table 3 the value of Costa Rica's exports increased about 60 percent in 1977 over 1975. At the same time, the international banking system had large amounts of deposits from petroleum producing countries they were recycling back into non-oil producing countries such as Costa Rica. From 1973 to 1979 Costa Rica increased its public sector foreign debt by about a half-billion dollars through these commercial sources (Table 3). Along with this, the World Bank, the Inter-American Development Bank and other donor agencies, between 1975 and 1980, added about 700 million dollars to Costa Rica's public sector external debt. Private external debt also increased rapidly during this period and amounted to another billion dollars U.S. in 1982.

While this was going on, the Costa Rican government expanded employment and expenditures in public and semi-public agencies. Instead of cutting back on public expenditures when export earnings leveled off after the boom in the late 1970s, the Costa Rican government continued to borrow large amounts in external markets, as well as within the country through the nationalized banking system. These loans were used to cover growing internal budget deficits. Massive government borrowing increasingly crowded out private firms from both external and internal credit markets. This, combined with other factors, caused the economic downturn in the economy. Concurrently, the deficits, government

Table 3. Economic Performance Indicators for Costa Rica, 1960-1981

Year	Exchange Rate	Inflation Rate	Value of Imports	Value of Exports	Change in For. Ex. Res.	External Debt[b] External Donors[c]	External Debt[b] Commercial Banks[d]
	Colones per $1 U.S.[a]	Wholesale Price Index	--In Millions of Dollars--				
1960	5.64	6	110	84	- 3	24	4
1961	6.64	- 1	107	84	- 5	24	4
1962	6.64	2	113	93	5	45	16
1963	6.64	1	124	95	5	73	17
1964	6.64	2	139	114	2	81	23
1965	6.64	- 2	178	112	2	113	35
1966	6.64	2	179	136	- 2	124	37
1967	6.64	5	191	144	2	127	26
1968	6.64	4	214	171	10	148	17
1969	6.64	6	245	180	18	137	20
1970	6.64	8	317	231	- 16	131	33
1971	6.64	4	350	225	8	153	46
1972	6.64	8	373	281	2	178	59
1973	6.65	26	455	345	18	203	93
1974	8.57	38	720	440	- 23	251	128
1975	8.57	14	694	493	21	343	168
1976	8.57	7	770	593	65	430	216
1977	8.57	7	1,021	828	109	520	314
1978	8.57	9	1,166	865	- 41	632	412
1979	8.57	24	1,397	934	-106	759	639
1980	14.25	22	1,540	1,002	-204	1,087	648
1981	35.80	82	1,211	1,031	- 52	1,700	1,000[e]

a/ End of year official selling exchange rates.
b/ Year end outstanding balances.
c/ Includes multilateral as well as bilateral assistance.
d/ Includes suppliers credits.
e/ Preliminary figures as of October 1, 1981.

Sources: Victor Hugo Cespedes and Claudio Gonzalez-Vega, "Growth and Equity: Income Distribution in Costa Rica," manuscript in process, September 1982; Victor Hugo Cespedes S. and others, Costa Rica: Una Economia en Crisis. San Jose, Costa Rica: Academia de Centroamerica, Dec. 1981; and Oficina de Planificacion Nacional y Politica Economia, Evolucion Socio Economica de Costa Rica, 1950-1980, San Jose, Costa Rica: Editorial Universidad Estatal A Distancia, 1982.

borrowings, and rapid increases in the money supply caused a sharp increase in the rate of inflation and capital flight from the country.

An important factor that caused the government to resist adjusting exchange rates was the recently acquired, very large foreign debt obligation, one of the highest per capita in the world. Most of this debt was denominated in foreign currency. A devaluation of say 100 percent would have doubled the debt obligation in terms of the local currency. No government, especially one as heavily indebted as Costa Rica's, wants to face the very tough short run adjustments in government budgets required by massive increases in the debt service obligation.

It is clear that international lenders loved Costa Rica nigh onto death. During the late 1970s Costa Rica should have increased its domestic savings, and followed trade policies aimed at encouraging a few efficient industries to emerge that could have been competitive in international markets. With a smaller overhang of foreign debt, and more efficient industries, it would have been easier for the government to make modest adjustments in the exchange rate to help manage some of the unanticipated shocks that occur to any small, relatively open economy.

Dominican Republic's Financial Markets

A large part of donor assistance moves through local financial markets. Its impacts are largely on the policies years these rates have been well below the rates of inflation. The rediscount facilities and the large amounts of external funds for credit also encourage financial intermediaries to become heavily dependent on outside funds. Aside from a few branches of commercial banks, there are very few opportunities for rural residents in the Dominican Republic to place their savings in financial institutions. While authorized to do so, the Agricultural Bank accepts virtually no deposits in any of its more than 30 branches.

Low interest rates make it very difficult for the financial system, even if it chooses to do so, to mobilize voluntary financial savings in rural areas. The low interest rates also make it impossible for a lending agency to cover its costs of lending, especially if it makes a large number of small loans to the rural poor. No lender, even if owned by the government, can expect to subsist indefinitely on a diet of subsidies to cover operating deficits. The political will to sustain these subsidies is transitory. The net result is that benefits of borrowing are concentrated in the hands of relatively few people, financial markets do a poor job of helping to allocate resources efficiently, and the financial system takes on a patronal flavor (Ladman and Tinnermeier). The net result is that only 10-15 percent of the farmers in the Dominican Republic have access to formal loans, agricultural lenders are on shaky financial grounds, and information flows within agricultural lenders that influence the performance of the financial market. These impacts can be grouped into four categories: (1) interest rate policies, (2) sources of funds used by the financial markets, (3) information flows within these markets, and (4) political intrusions into these markets.

It is difficult through a single case to show the subtleties of how substantial donor intrusions affect financial intermediation. While far from being the worst case, the Dominican Republic does illustrate some of the problems associated with donor intrusions into rural financial markets.

As can be noted in Table 4, since 1960 the funds handled by formal rural financial markets in the Dominican Republic have expanded rapidly, despite modest inflation, from 15 to over 240 million pesos. The growth in the volume of agricultural loans made by the Agricultural Bank has been especially impressive. Over the past two decades donor agencies have played a large role in this expansion. Through 1982 donor agencies have granted or lent for agricultural credit purposes in the Dominican Republic about 150 million dollars U.S. (Donor agencies have also been very important in the formation of several major segments of the agricultural credit system.) These large infusions of funds have allowed the government to sustain relatively low interest rates on both rural loans and savings. In recent

Table 4. Volume of Formal Agricultural Loans Made in The Dominican Republic, 1960-1981[a]

Year	Total[a]	Agricultural Bank	Commercial Banks[b]	Other Lenders[c]	Ratios of Credit-to Output[e]	Ratios of Ag. Credit-to Total Credit
	--Millions of Pesos[d]--					
1960	15.3	12	3.3	--	0.06	
1962	14.1	11	3.1	--	0.05	
1964	29.0	24	5.0	--	0.11	
1966	33.5	21	12.2	0.3	0.13	
1968	42.5	25	15.2	2.3	0.16	
1970	45.4	29	15.5	0.9	0.13	
1972	54.7	31	21.1	2.6	0.13	0.20
1974	119.4	68	46.9	4.5	0.18	0.21
1976	151.9	81	61.9	9.0	0.19	0.20
1978	192.9	112	67.4	13.6	0.21	0.23
1980	278.0	189	89.0	N/A	0.29[f]	0.25[f]
1981	240.3	149	91.3	N/A	N/A	N/A

a/ Does not include loans large firms may obtain outside the country (i.e. the sugar industry).
b/ Excludes loans to the sugar industry.
c/ Includes loans made by the Dominican Development Foundation, IDECOOP, various financieras, ODC, and CARITAS.
d/ The official exchange rate is one peso for one U.S. dollar. The curb exchange rate has ranged between the official rate and 1.50 in recent years.
e/ Output is value of total internal gross product from the agricultural sector.
f/ Excludes financieras, ODC, CARITAS, DDF, IDECOOP.

Sources: Banco Agricola de La Republica Dominicana, Boletin Estadistico, 1981; Banco Central de La Republica Dominicana, Boletin Mensual various issues, and various unpublished reports by agencies making agricultural loans in the Dominican Republic. Also, USAID/DR, Agricultural Sector Strategy--Dominican Republic, 1980; and SEA, Plan de Desarrollo Agropecuario 1980-82, 1979.

are warped toward meeting donor objectives rather than providing information for efficient management.

Conclusions

Because of fungibility, it is very difficult to sort shadow from reality in foreign aid (Tendler). While I feel that foreign assistance should be continued, I am very concerned about how large amounts of capital or commodity assistance affect agricultural prices, exchange rates, and interest rates. It is becoming increasingly clear that faulty internal price policies, not the lack of foreign assistance, is the major factor causing many low income countries to falter. To the extent that foreign aid helps reinforce these damaging policies, more donor assistance will be part of the problem not part of the solution. A major challenge facing the foreign aid enterprise is to reposition aid activities so they encourage appropriate changes in these misguided policies.

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